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BEFORE THE ARIZONA CORPORATION COMMISSION

AZ CORP COMMISSION
DOCKET CONTROL

COMMISSIONERS

BOB STUMP, Chairman
GARY PIERCE
BRENDA BURNS
BOB BURNS
SUSAN BITTER SMITH

2013 OCT 15 PM 2 49

In the matter of:

MARK DANA HUGHES, CRD# 1843511,
and DOLLY A. HUGHES, husband and
wife,

and

LEGACY FINANCIAL ADVISORS,
L.L.C., CRD# 114029, an Arizona limited
liability company,

Respondents.

DOCKET NO. S-20864A-12-0439

SECURITIES DIVISION'S POST-HEARING
BRIEF

Arizona Corporation Commission

DOCKETED

OCT 15 2013

DOCKETED BY

The Securities Division ("Division") of the Arizona Corporation Commission ("Commission") submits its Post-Hearing Brief ("Brief") with respect to the administrative hearing held on August 26-27, 2013. This Brief is supported by the following Memorandum of Points and Authorities.

MEMORADUM OF POINTS AND AUTHORITIES

I. PROCEDURAL HISTORY

On October 17, 2012, the Division filed a Notice of Opportunity for Hearing Regarding Proposed Order to Cease and Desist, Order for Restitution, Order of Revocation, Order for Administrative Penalties, and for Other Affirmative Action ("Notice"). The Notice alleged that Respondents MARK DANA HUGHES and LEGACY FINANCIAL ADVISORS, L.L.C., engaged in acts, practices, and transactions that constituted violations of Arizona Investment Management Act, A.R.S. § 44-3101 et seq. ("IM Act").

1 DOLLY A. HUGHES, the spouse ("Respondent Spouse") of Respondent MARK DANA
2 HUGHES, was joined in the action pursuant to A.R.S. § 44-3291(C) solely for the purpose of
3 determining the liability of their marital community.

4 Respondents MARK DANA HUGHES, LEGACY FINANCIAL ADVISORS, L.L.C., and
5 Respondent Spouse were duly served with copies of the Notice.

6 On November 2, 2012, MARK DANA HUGHES, LEGACY FINANCIAL ADVISORS,
7 L.L.C., and Respondent Spouse requested a hearing.

8 The hearing was held August 26-27, 2013.

9 Respondents MARK DANA HUGHES, LEGACY FINANCIAL ADVISORS, L.L.C., and
10 Respondent Spouse did not appear for the hearing.

11 Administrative Law Judge Marc E. Stern admitted Division Exhibits S-1 through S-82 into
12 evidence. (*Tr. p. 13, ll. 21-22 and p. 14, ll. 4-5*).

13 II. STANDARD OF PROOF

14 In administrative actions brought by the Commission, the well-recognized standard of proof
15 for alleged violations of the Act is the "preponderance of the evidence." *See, e.g., Steadman v.*
16 *Securities and Exchange Comm'n*, 450 U.S. 91 (1981) (Securities and Exchange Commission
17 properly applied the 'preponderance of the evidence' standard when determining administrative
18 proceeding); *Geer v. Ordway*, 156 Ariz. 588, 589, 754 P.2d 315, 316 (Ct. App. 1987) (in context of
19 administrative hearing, proper standard of proof is preponderance of the evidence). Therefore, the
20 preponderance of the evidence standard is applicable in this matter.

21 III. JURISDICTION

22 The Commission has jurisdiction over this matter pursuant to Article XV of the Arizona
23 Constitution and the IM Act.

24 ...

25 ...

26 ...

IV. FACTS

MARK DANA HUGHES (CRD# 1843511). ("HUGHES") is a married man and was at all relevant times residing in Arizona. (*Answer at paragraph 3 and Ex. S-56, p. 8, ll. 9-24 and p. 9, ll. 7-8*).

Respondent Spouse and HUGHES are husband and wife and have been married during all relevant times. (*Answer at paragraph 4, and Ex. S-56 at p. 19, ll. 8-16*).

HUGHES operated LEGACY FINANCIAL ADVISORS, L.L.C. (CRD# 114029) ("LFA") as a sole proprietorship. (*Exs. S-2 and Ex. S-56, p. 10, ll. 2-8*). In or around April 2008, LFA, which was owned and operated by HUGHES, became licensed as an investment adviser in Arizona. (*Answer at paragraph 4, and Tr. at p. 99, ll. 3-5*). On December 8, 2009, HUGHES organized LFA as an Arizona limited liability company. (*Answer at paragraph 4, and Exs. S-3a and S-3b*). At all relevant times, LFA had its principal place of business in Tucson, Arizona. (*Answer at paragraph 4, and Exs. S-3a and S-3b*).

At all relevant times, HUGHES held several official positions with LFA. HUGHES was LFA's sole owner, member, managing member, compliance officer, and investment adviser representative. (*Exs. S-3a, S-3b, S-13 at p. ACC088746, and S-56 at p. 10, ll. 2-8*).

Steven Steger ("Steger"), the Division's Financial Institutions Examiner, testified that HUGHES was never licensed as an investment adviser representative while with LFA. (*Tr. p. 101, ll. 7-25 to p. 102, ll. 1-5, and Ex. S-55*).

HUGHES and Respondent Spouse held one joint back account. (*Tr. p. 113, ll. 21-25 and Ex. S-79 at ACC000003*). HUGHES did not have a separate account for LFA, contrary to his testimony during his examination under oath. (*Tr. p. 114, ll. 5-25, to p. 115, ll. 1-17, and Ex. S-79 at ACC000001*).

LFA'S ADVISORY RELATIONSHIP WITH ITS CLIENTS

Each of the clients had an advisory relationship with LFA wherein each client granted to LFA, through HUGHES, the authority to act for them in furtherance of managing their accounts.

1 Clients Robin Jones, Hank Masek, and Henry and Sanda Clark each executed Investment
2 Management Agreements with LFA that outlined its advisory services. (*Exs. S-14 at ACC088829*
3 *to ACC088835, S-15 at ACC089015 to ACC089021, and S-21 at ACC089778 to ACC089784*).

4 Two of the pertinent provisions of LFA's Investment Management Agreements are account
5 management and fees. Clients Robin Jones, Hank Masek, and Henry and Sanda Clark each agreed
6 to open a discretionary account which authorized LFA "to buy, sell, or otherwise trade securities or
7 other investments in the Account[s] without discussing the transactions with the Client in advance."
8 (*Exs. S-14 at ACC088829, S-15 at ACC089015, and S-21 at ACC089778*). LFA agreed to "make
9 investment decisions for the Account[s] according to the investment objectives and financial
10 circumstances" of Robin Jones, Hank Masek, and Harry and Sanda Clark. (*Id.*). To pay for this
11 service, LFA and Robin Jones, Hank Masek, and Harry and Sanda Clark each agreed to a fee that
12 would be charged quarterly and payable in advance with an automatic deduction from their
13 accounts paid directly to LFA. (*Exs. S-14 at ACC088830, S-15 at ACC089016, and S-21 at*
14 *ACC089779*).

15 **LFA/HUGHES TRADING**

16 Steger testified from January 2009 until HUGHES closed his client trading accounts at the
17 end of June 2012, HUGHES traded almost exclusively in all LFA client accounts in leveraged
18 Exchange Traded Funds ("ETFs"). (*Tr. p. 124, l. 5 to p. 137, ll. 1-11, and Exs. S-18 to S-19, S-22,*
19 *S-24 to S-36, S-40 to 48, S-50 to S-54, and S-68 to S-75*). The ETFs traded by LFA and HUGHES
20 magnified the performance of a stated index by two or three times, depending on the particular
21 ETF, and were meant to be traded frequently with a minimal holding period. (*Exs. S-40 to S-48,*
22 *and S-50 to S-54*). The disclosures associated with these ETFs advised investors that the ETFs do
23 "not seek to achieve its stated investment objective over a period of time greater than one day."
24 (*Exs. S-40 to S-48, and S-50 to S-54*).

25 These ETFs presented a series of risks. First, there is leverage risk. (*Exs. S-40 to S-48, and*
26 *S-50 to S-54*). Whether the ETF was leveraged two or three times, the result is a reduction of 2 or

3 percent for each 1 percent daily increase, excluding the costs of financing and operating the fund. (Exs. S-40 to S-48, and S-50 to S-54). Second, there is inverse risk. (Exs. S-40 to S-48, and S-50 to S-54). If the underlying index moves in the opposite direction than expected, there will be a loss of funds. (Exs. S-40 to S-48, and S-50 to S-54). Third, the underlying index itself may be risky. (Id.). For example, an index consisting of small and/or mid-sized capitalized companies present greater investment risk than found with larger more established companies. (Exs. S-40 to S-48, and S-50 to S-54).

THE ETFs TRADED BY LFA/HUGHES

Steger testified from January 2009 until HUGHES and LFA closed their client accounts at the end of June 2012, almost all of the securities traded by HUGHES in LFA's client accounts involved leveraged and/or inverse ETFs. (Tr. p. 124, l. 5 to p. 137, ll. 1-11, and Exs. S-18 to S-19, S-22, S-24 to S-36, S-40 to 48, S-50 to S-54, and S-68 to S-75). Each of these ETFs was designed to correspond to a multiple of the daily price performance of an underlying index. (Exs. S-40 to 48, S-50 to S-54). The majority of transactions effected in LFA client accounts involved the following inverse and/or leveraged ETFs:

- EDC - Direxion Daily Emerging Markets Bull 3x Shares – the underlying index is the MSCI Emerging Markets Index.
- EDZ - Direxion Daily Emerging Markets Bear 3x Shares – the underlying index is the MSCI Emerging Markets Index.
- ERX - Direxion Daily Energy Bull 3x Shares – the underlying index is the Energy Select Sector Index.
- ERY - Direxion Daily Energy Bear 3x Shares– the underlying index is the Energy Select Sector Index.
- FAS - Direxion Daily Financial Bull 3X Shares – the underlying index is the Russell 1000A® Financial Service Index.
- FAZ - Direxion Daily Financial Bear 3x Shares– the underlying index is the Russell 1000A® Financial Service Index.

- 1 • TNA - Direxion Daily Small Cap Bull 3x Shares - the underlying index is the Russell 2000® Index.
- 2 • TYH - Direxion Daily Technology Bull 3X Shares¹ - the underlying index is the Russell 1000® Technology Index.
- 3
- 4 • TYP - Direxion Daily Technology Bear 3X Shares² - the underlying index is the Russell 1000® Technology Index.
- 5
- 6 • TZA - Direxion Daily Small Cap Bear 3x Shares – the underlying index is the Russell 2000® Index.
- 7
- 8 • URE - ProShares Ultra Real Estate 2x Shares – the underlying index is the Dow Jones U.S. Real Estate Index.
- 9
- 10 • TBT – ProShares Ultra Short 20+ Year Treasury 2x Shares – the underlying index is the Barclays Capital U.S. 20+ Year Treasury Index

11 (*Exs. S-18 to S-19, S-22, S-24 to S-36, S-40 to 48, S-50 to S-54, and S-68 to S-75*).

12 The prospectuses pertaining to these ETFs explicitly state that they employ leveraging and
 13 that the ETFs should not be expected to achieve their stated objectives when held longer than one
 14 day. (*Exs. S-40 to S-48, and S-50 to S-54*). One example of a leveraged ETF that HUGHES traded
 15 for his clients was TZA. (*Ex. S-40*). TZA is a 3x leveraged, inverse ETF. (*Id.*). It does not invest
 16 in equity securities; in fact, it is 100 percent invested in derivatives. (*Id.*). Regarding the
 17 derivatives, the TZA prospectus says TZA “uses investment techniques such as futures and forward
 18 contracts, options and swaps, which may be considered aggressive.” (*Id.*).

19 The TZA (“Fund”). prospectus offered the following as important information:

20 The pursuit of daily leveraged goals means that the Fund is riskier
 21 than alternatives that do not use leverage because the Fund’s
 22 objective is to magnify the performance of the [Russell 2000] Index.
 23 The pursuit of daily leveraged investment goals means that the return
 24 of the Fund for a person longer than a full trading day may bear no
 25 resemblance to -300% of the return of the Index for such longer
 26 period because the aggregate return of the Fund is the product of the
 series of daily leveraged returns for each trading day. (*Ex. S-40*).

Regarding TZA’s investment objective, the TZA prospectus said:

¹ TYH trades under a new symbol: TECL.

² TYP trades under a new symbol: TECS.

1 The Fund seeks daily investment results, before fees and expenses, of
2 300% of the inverse (or opposite) of the performance of the Russell
3 2000® Index ("Index").. **The Fund seeks daily leveraged**
4 **investment results and does not seek to achieve its stated**
5 **investment objective over a period of time greater than one day.**
6 The Fund is different and much riskier than most exchange-traded
7 funds.

8 **The Fund is designed to be utilized only by knowledgeable**
9 **investors who understand the potential consequences of seeking**
10 **daily leveraged investment results, understand the risks**
11 **associated with shorting and the use of leverage, and are willing**
12 **to monitor their portfolios frequently. The Fund is not intended**
13 **to be used by, and is not appropriate for, investors who do not**
14 **intend to actively monitor and manage their portfolios.** (emphasis
15 in the original) (Ex. S-40).

16 Besides the risk associated with inverse and leveraging, there is also the risk with the
17 underlying market Index. The TZA prospectus said, "Investing in the securities of small and/or
18 mid-capitalization companies involves greater risks and the possibility of greater price volatility
19 than investing in more-established, larger capitalization companies." (Ex. S-40).

20 The other ETFs in the client accounts, EDC, EDZ, ERX, ERY, FAS, FAZ, TNA, TYH,
21 TYP, URE, and TBT share similar characteristics to the TZA ETF. (Exs. S-40 to S-48 and S-50 to
22 S-54). The other ETFs share similar risks of leverage, whether 2x or 3x, inverse risk, and
23 underlying index risk. (Exs. S-40 to S-48 and S-50 to S-54). Additionally, the prospectuses also
24 state the ETFs should be held no longer than one day. (Exs. S-40 to S-48 and S-50 to S-54).

25 CLIENT-ROBIN JONES

26 Robin Jones ("Jones") testified that she is married to Royce Eldon Jones. (Tr. p. 28, ll. 2-3).
Jones testified she and her husband met HUGHES and LFA through one of her husband's business
partners in the late 1980s or early 1990s. (Tr. p. 28, ll. 14-17). Jones and her husband were
residents of Clovis, New Mexico while HUGHES resided in Arizona. (Tr. p. 29, ll. 17-22).

HUGHES met with Jones and her husband and discussed their goals and objectives to reach
retirement. (Tr. p. 29, ll. 15-16). At the time, Jones was 37 years old and her husband was 54
years old. (Tr. p. 31, ll. 5-7). Their time horizon was to retire, for her husband, between ages 62 to

1 65, and for her, one year later. (*Tr. p. 31, ll. 13-16*). They had no other funds available other than
2 \$10,000 in another account. (*Tr. p. 31, ll. 23-25 to p. 32, ll. 1-3*). They had no investment
3 experience or knowledge. (*Tr. p. 32, ll. 4-9*).

4 HUGHES met with Jones and her husband and had them go through a Client Profile and
5 Risk Assessment questionnaire. (*Ex. S-15*). Their goal was to reach \$1 million with their net
6 income of \$250,000 per year. (*Tr. p. 31, ll. 17-22, p. 37, ll. 4-6, and Ex. S-15*). Based on their
7 goals, HUGHES assessed their investment objective as moderate to moderately aggressive. (*Tr. p.*
8 *37, ll. 13-24 and Ex. S-15*). At the time they agreed with the assessment provided by HUGHES.
9 (*Tr. p. 38, ll. 7-9*).

10 Based on the information in the Client Profile and Risk Assessment questionnaire,
11 HUGHES and LFA prepared the Investment Policy Statement for Jones and her husband. (*Tr. p.*
12 *38, ll. 10-17 and Ex. S-15*). HUGHES discussed the Investment Policy Statement with Jones and
13 her husband, including explaining the investment returns over the long run and the model asset
14 allocation portfolio. (*Tr. p. 32, ll. 14-25, p. 33, ll. 8-19, p. 34, ll. 10-16, and Ex. S-15 at ACC*
15 *089004 and 089006*). Additionally, he told them he would act according to the Investment Policy
16 Statement. (*Tr. p. 32, ll. 14-25, p. 33, ll. 8-19, p. 34, ll. 10-16, and Ex. S-15 at ACC 089004 and*
17 *089006*).

18 The model asset allocation portfolio ("portfolio") prepared by HUGHES and LFA for Jones
19 and her husband included investing in a diverse set of equities, stocks, and bonds. (*Ex. S-15 at*
20 *ACC089006*). The portfolio was based on their financial resources, financial goals, time horizon,
21 tax status, holding limitations, and risk tolerance. (*Id.*). The portfolio "balances risk and reward
22 and attempts to achieve the stated objectives of the investment program." (*Id.*). The portfolio
23 included 25 percent in corporate bonds, 21 percent in large value stocks, 21 percent in large growth
24 stocks, and the remainder made of other stocks. (*Id.*).

25 HUGHES managed Jones and her husband's account without any changes from Jones. (*Tr.*
26 *p. 34, ll. 18-25 to p. 35, ll. 1-3*). HUGHES was in complete control of the decision making for the

1 Jones account. (*Id.*). Jones and her husband signed, along with HUGHES, LFA's Investment
2 Management Agreement agreeing that HUGHES would open and maintain the account and make
3 investment decisions for the Jones account according to their investment objectives and
4 circumstances. (*Ex. S-15 at ACC089015 and ACC089021*).

5 Initially, Jones agreed with HUGHES to a moderate to moderately aggressive investment
6 objective; however, in August 2008 Jones and her husband had a change in their financial
7 circumstances. Jones testified that her husband had a heart attack on August 22, 2008, and then on
8 August 25, 2008, had a quadruple bypass. (*Tr. p. 38, ll. 23-25*). Jones then contacted HUGHES
9 instructing him to implement a more conservative investment strategy because their LFA account
10 consisted of their retirement funds and they could not afford to incur any losses as Jones did not
11 know if her husband would return to work. (*Tr. p. 39, ll. 1-5, and 14-18*). Jones testified that
12 because of her husband's heart attack they may need their retirement funds to live on. (*Tr. p. 40, ll.*
13 *9-13*).

14 Jones also conveyed her conservative investment objective in an email. About six weeks
15 after her husband's heart attack, Jones asked HUGHES about placing their funds in certificates of
16 deposit to preserve the funds. (*Tr. p. 48, ll. 6-22, and Ex. S-81*).

17 Jones testified she received account statements from TD Ameritrade and Scottrade. (*Tr. p.*
18 *42, ll. 14-16, and Exs. S-18 to S-19*). However, while she understood that there were buys and sells
19 in the account, she had no idea of the type of securities HUGHES bought nor whether or not they
20 met her objectives. (*Tr. p. 44, ll. 18-22, and p. 45, ll. 9-13*). Jones assumed that HUGHES made
21 the purchases and sales in accordance with her investment objectives. (*Tr. p. 56, ll. 10-15*).
22 HUGHES disregarded her instructions by trading almost exclusively and frequently in highly
23 volatile, leveraged ETFs. (*Tr. p. 56, ll. 6-12*).

24 Jones testified HUGHES was in contact with her, mostly while the account was doing well;
25 however, when the account started to lose money, it was Jones that drove the communications,
26 either through a telephone call or an email. (*Tr. p. 46, ll. 16-22*). Jones also testified that for the

1 year or so prior to June 2012 HUGHES was hostile towards her inquires. (*Tr. p. 50, ll. 21-24 to p.*
2 *51, ll. 3-5*). Jones described the conversations as short, tense, and hostile. (*Tr. p. 50, ll. 22-24*).
3 Jones testified she was afraid to move the account to another planner too soon for fear that what
4 remained in her account would be gone. (*Tr. p. 50, ll. 24-25 to p. 51, ll. 1-5*).

5 Jones testified that HUGHES and LFA sent an email at the end of June 2012 announcing
6 they would no longer be managing her account. (*Tr. p. 50, ll. 1-3, and Ex. S-17*). This was sudden
7 and without warning. (*Ex. S-17*). HUGHES indicated that her account would be in three or four
8 investments that could be held for the foreseeable future. (*Tr. p. 50, ll. 4-11 and Ex. S-17*). Paul
9 Litteau, the Division's securities expert, testified that, after settlement, HUGHES included in the
10 Jones account two speculative securities, ones that could not be held for the foreseeable future. (*Tr.*
11 *p. 172, ll. 1-34, p. 183, ll. 22-25 to p. 184, ll. 1-9, and Exs. S-1 and S-19 at ACC003940 to*
12 *ACC003944*).

13 Jones testified she had her new financial planner look at her account. Jones testified her
14 new planner said the investment HUGHES had her in "were much too aggressive for [them]" and
15 that [HUGHES] was trading the investments incorrectly. (*Tr. p. 51, ll. 8-12*). Jones testified her
16 new planner said what HUGHES left for her in her account were not investments she could hold for
17 the foreseeable future. (*Tr. p. 50, ll. 12-17*).

18 Jones testified that she never told HUGHES she could afford to lose that money. (*Tr. p. 52,*
19 *ll. 13-25*). In fact, as a result of HUGHES' trading, Jones will have to work 10 to 12 more years
20 instead of enjoying her time with her husband and celebrating life. (*Tr. p. 52, ll. 1-6*).

21 Paul Litteau ("Litteau"), a securities industry expert with over 40 years of experience, was
22 admitted as an expert. (*Tr. p. 172, ll. 1-34, and Ex. S-1*). Litteau was retained by the Division to
23 analyze whether HUGHES and LFA traded in suitable securities for their clients. (*Tr. p. 172, ll. 9-*
24 *17*). Litteau described suitability as "a recommendation made for a customer [that] should be
25 appropriate or suitable in light of the customer's investment objectives, financial resources, time
26 horizon, age, tax considerations, and various other relevant factors." (*Tr. p. 172, ll. 24-25 to p. 173,*

1 ll. 1-3). In the case of an adviser with discretionary power over an account, "every decision made
2 for that customer has to be consistent with the investment projections and needs for the customer."
3 (*Tr. p. 173, ll. 13-15*).

4 Litteau reviewed the Investment Policy Statement and Client Profile and Risk Assessment
5 questionnaire (collectively "investment documents") and account statements for Jones for the time
6 period of January 2009 until June 2012. (*Tr. p. 174, ll. 6-20, p. 175, ll. 7-13, and Exs. S-15, S-18,*
7 *and S-19*). Litteau testified that the asset allocation in the investment documents is consistent with
8 a moderate to moderately aggressive portfolio. (*Tr. p. 175, ll. 20-25 and Ex. S-15*). Litteau
9 testified that the asset allocation would be a benchmark of what to expect because that is what the
10 customer is being told. (*Tr. p. 176, ll. 4-7 and Ex. S-15*). Litteau testified that HUGHES attempted
11 in the first few months to reach an asset allocation similar to what was found in the investment
12 profile, but thereafter HUGHES traded almost entirely in the volatile and leveraged ETFs. (*Tr. p.*
13 *176, ll. 19-25 to p. 177, l. 1, p. 181, ll. 8-10, and Exs. S-18 and S-19*). Litteau said in an account
14 such as the Jones account, HUGHES should not have traded the ETFs because Jones and her
15 husband were neither aggressive nor speculative. (*Tr. p. 177, ll. 14-17*).

16 In his opinion, Litteau said that from January 2009 until June 2012, the ETFs traded for
17 Jones were not suitable because the ETFs were highly volatile and leveraged, and were inconsistent
18 with Jones' investment objective, financial situation, and investment experience. (*Tr. p. 177, ll. 14-*
19 *17, p. 181, ll. 23-25 and p. 182, ll. 4-8*). Furthermore, the trading of the volatile, leveraged ETFs
20 was compounded by the fact that the Jones account was an individual retirement account ("IRA").
21 (*Tr. p. 182, ll. 1-3*). Litteau said short term trading in an IRA is inappropriate because of
22 prohibitions against the use of leverage and short positions in a retirement account. (*Tr. p. 182, ll.*
23 *1-3 and p. 187, ll. 11-18*).

24 Denise Fritz ("Fritz"), the Division's forensic accountant, prepared a report of the Jones
25 account that summarized the activity in the accounts from January 2009 until June 2012. (*Tr. p.*
26 *206, ll. 5-12 and Ex. S-64*). Using the trading statements to prepare this report, Fritz first

1 determined the beginning balance as of January 1, 2009, which was \$318,194.03, before any
2 trading activity occurred on January 1, 2009. (*Tr. p. 206, ll. 19-20, p. 207, ll. 13-14, and ll. 18-23,*
3 *and Ex. S-64*). Fritz further testified that at the end of December 31, 2010, the account lost over
4 \$200,000, which was as a result of the trading activity in the account, and not due to any
5 disbursements. (*Tr. p. 209, ll. 6-24 and Ex. S-64*). This loss occurred even though \$98,901 was
6 deposited into the account. (*Tr. p. 210, ll. 22-25 to p. 211, ll. 1-6 and Ex. S-64*). Fritz performed
7 the same analysis of the trading activity that occurred when the account was moved from TD
8 Ameritrade to Scottrade. In total, Fritz testified that the Jones account, from January 1, 2009, until
9 June 30, 2012, lost \$234,317.24 due to the trading activity in the accounts. (*Tr. p. 211, ll. 24-25 to*
10 *p. 212, ll. 1-2 and ll. 11-15, and Ex. S-64*).

11 CLIENT-HENRY MASEK

12 Henry Masek ("Masek") testified he was a retired police officer living in Vail, Arizona.
13 (*Tr. p. 58, ll. 1-12*). Masek testified he had retirement funds from a DROP account, which was an
14 Arizona public safety account. (*Tr. p. 59, ll. 2-10*). Masek testified that he "knew pretty much
15 nothing about the investment (sic), that's why [he] needed to hire somebody to take care of it for
16 [him]." (*Tr. p. 62, ll. 22-24*). Masek testified he does not understand "financial stuff at all," so he
17 brought his son along for "interpretation." (*Tr. p. 59, ll. 16-19*).

18 Masek met HUGHES and LFA through a referral from Masek's tax preparer. (*Tr. p. 59, l. 2*
19 *and ll. 7-10*). Masek testified that he told HUGHES the funds in his DROP account were
20 earmarked to pay his mortgage so he could maintain the same position in retirement as he had when
21 he was working. (*Tr. p. 60, ll. 9-10 and ll. 16-17*). Masek further testified that he told HUGHES
22 that he would receive 50 percent of his income in the form of a pension when he retired, that his
23 mortgage payment used 50 percent of his income when he worked, and that since he allocated the
24 DROP funds for his mortgage, his 50 percent pension would leave him in the same position as if he
25 was working. (*Tr. p. 60, ll. 12-18*).

26 Masek testified HUGHES had him fill out a questionnaire regarding his risk tolerance. (*Tr.*

1 *p. 60, ll. 23-24 and Ex. S-21 at ACC089750*). After filling it out, Masek initialed near the bottom
2 of the page near the bracketed word, "moderate," as his risk tolerance. (*Tr. p. 63, ll. 15-19 and Ex.*
3 *S-21 at ACC089750*). Masek explained that he and HUGHES discussed Masek's questionnaire and
4 mutually agreed that Masek had a moderate risk tolerance. (*Tr. p. 63, ll. 6-9 and Ex. S-21 at*
5 *ACC089750*).

6 Masek testified that HUGHES and LFA prepared an Investment Policy Statement based on
7 his time horizon, his available funds, and his objectives. (*Tr. p. 67, ll. 6-11 and Ex. S-21*). The
8 Investment Policy Statement essentially laid out an investment strategy for Masek which included
9 an asset allocation portfolio for Masek's investment program. (*Ex. S-21 at ACC089746*). Masek
10 testified his time horizon was 25 years, representing the time left on his mortgage, possessed only
11 \$241,000, except for an additional \$2,000 in cash, and his objective was moderately conservative.
12 (*Tr. p. 65, ll. 4-21 and Ex. S-21 at ACC089744*).

13 The model asset allocation portfolio ("portfolio") prepared by HUGHES and LFA for
14 Masek included investing in a diverse set of bonds and stocks. (*Ex. S-21 at ACC089746*). The
15 portfolio was based on Masek's financial resources, financial goals, time horizon, tax status,
16 holding limitations, and risk tolerance. (*Id.*). The model portfolio "balances risk and reward and
17 attempts to achieve the stated objectives of the investment program." (*Id.*). The portfolio included
18 nearly 44 percent in bonds, 12.42 percent in large value stocks, and others stocks. (*Id.*).

19 Masek testified he hired HUGHES and LFA to manage his funds beginning in July 2011.
20 (*Tr. p. 69, ll. 14-17, p. 78, ll. 20-22, and S-22*). Masek testified that HUGHES had complete
21 control of his account. (*Tr. p. 67, ll. 21-25 to p. 68, ll. 1-3*). Masek signed LFA's Investment
22 Management Agreement along with HUGHES authorizing HUGHES to open and maintain the
23 account and make investment decisions for Masek account according to his investment objectives
24 and circumstances. (*Ex. S-21 at ACC089752 and ACC089758*). Masek trusted HUGHES to
25 manage his account because Masek was not knowledgeable about investing. (*Tr. p. 67, ll. 21-25 to*
26 *p. 68, ll. 1-3*).

1 Masek also testified he told HUGHES that he “was not a gambler with this money, that [he]
2 couldn’t afford to lose it, that that’s what it was specifically designed for. Because that [DROP]
3 money was just a little over what my mortgage balance was.” (*Tr. p. 60, l. 25 to p. 61, ll. 1-4*).

4 Masek testified he received account statements from Scottrade and was concerned with “the
5 bottom line,” what his account was worth at the end of each month. (*Tr. p. 69, ll. 18-25 and Ex. S-
6 22*). Masek noticed that his account was “dropping, dropping, dropping.” (*Tr. p. 72, ll. 1-2*).
7 Masek testified that he contacted HUGHES either every month or every other month about his
8 account performance and HUGHES explained it away by saying it is the “seven year curve,” and
9 “remember the seven year curve.” (*Tr. p. 71, ll. 10-12, p. 71, ll. 20-24*). Masek testified HUGHES
10 explained the seven year curve as a cycle; “traditionally [stocks] would go up, kind of level out, go
11 to a point, and then maybe down.” (*Tr. p. 71, ll. 10-17*). On one occasion, HUGHES even told
12 Masek to stop looking at his account statements. (*Tr. p. 72, ll. 4-11*).

13 Masek testified he did not know whether or not the securities purchased in his account by
14 HUGHES were conservative, moderate, or aggressive. (*Tr. p. 73, ll. 8-25 to p. 74, ll. 1-11*).

15 Masek testified that his father-in-law told Masek how well his account was performing and
16 then Masek became more concerned about why his own account was declining. (*Tr. p. 75, ll. 5-
17 14*). Masek had his father-in-law’s investment adviser review Masek’s account in June 2012. (*Tr.
18 p. 75, ll. 15-18 and p. 76, ll. 12-17*). Masek testified that Mr. Hammond, Masek’s father-in-law’s
19 investment adviser, told him that the securities HUGHES purchased for him were “so outrageously
20 high risk [Mr. Hammond] didn’t understand how anybody could afford them.” (*Tr. p. 77, ll. 7-8*).
21 Mr. Hammond further said that HUGHES was not putting Masek’s funds into the type of stock that
22 he had agreed to with HUGHES. (*Tr. p. 84, ll. 7-12*). At that point, Masek terminated HUGHES
23 and LFA. (*Tr. p. 77, ll. 14-16*).

24 Masek testified that the loss in his account jeopardized his property to which the funds were
25 dedicated. (*Tr. p. 79, l. 6*). That property was the most important thing to him, next to his wife.
26 (*Tr. p. 79, ll. 24-25*). Because of how HUGHES managed his account, Masek now has \$119,000

1 with \$150,000 remaining on his mortgage. *(Tr. p. 80, ll. 3-6).*

2 Masek also testified that he trusted HUGHES to manage it according to his wishes. *(Tr. p.*
3 *80, ll. 9-12).* Masek, a former police officer, dealt with a lot of victims, and now he was one. *(Tr.*
4 *p. 80, ll. 13-15).*

5 Litteau reviewed Masek's account documents and records for the time period of July 2011
6 until May 2012. *(Tr. p. p. 174, ll. 6-16, p. 185, ll. 21-25 to p. 1-3, p. 187, l. 1, and Exs. S-21 and S-*
7 *22).* Litteau said Masek's trading records were not consistent with Masek's financial situation and
8 model portfolio. *(Tr. p. 186, ll. 10-23 and Exs. S-21 and S-22).* He saw similar trading activity in
9 Masek's account as he saw in the Jones account, rapid trading and very aggressive use of the
10 volatile and leveraged ETFs. *(Tr. p. 187, ll. 2-5 and Ex. S-22).* Masek's account was an IRA
11 account and the use of the volatile and leveraged ETFs circumvented the prohibitions against use of
12 leverage, margin, and short positions in a retirement account. *(Tr. p. 187, ll. 11-18).* Litteau said
13 virtually all the securities in the account were the leveraged ETFs. *(Tr. p. 188, ll. 2-3).* Litteau also
14 said the limited resources of Masek made HUGHES' aggressive trading strategy even more
15 inappropriate. *(Tr. p. 188, ll. 8-15).*

16 Litteau said the seven year curve would not explain losses in the account. *(Tr. p. 188, ll. 16-*
17 *20).* The seven year curve is a business cycle and the trading in Masek's account was inconsistent
18 with trying to track a business cycle because there was the rapid changing of positions from bullish
19 to bearish orientation. *(Tr. p. 188, ll. 16-20 to p. 189, ll. 1-2).*

20 For both the Masek and Jones accounts, there were times HUGHES was effectively long
21 and short in the same index. *(Tr. p. 189, ll. 3-10).* There is no purpose for doing this for clients
22 such as those with HUGHES. *(Tr. p. 189, 12-19).*

23 In his opinion, Litteau said that from July 2011 until June 2012, the ETFs traded for Masek
24 were not suitable because the ETFs were highly volatile and leveraged. *(Tr. p. 188, ll. 4-7 and p.*
25 *190, ll. 1-2).* Furthermore, these ETFs were not suitable for Masek (regardless of whether he was
26 moderate or moderately conservative) because they were inconsistent with his investment objective,

1 financial situation, and investment experience. (*Id.*).

2 Fritz prepared a report summarizing the activity of the Masek account from July 2011 until
3 June 2012. (*Tr. p. 214, ll. 2-11 and Ex. S-64*). Using the trading statements to prepare this report,
4 Fritz first determined that Masek deposited \$199,881.78 into his account to begin trading in July
5 2011. (*Ex. S-64*). Masek withdrew \$1,535 per month. (*Tr. p. 215, ll. 24-25 and Ex. S-64*). Fritz
6 testified that Masek, excluding the withdrawals, from July 2011 until June 2012, lost \$66,720.78
7 due to the trading in Masek's account. (*Tr. p. 215, ll. 6-16 and Ex. S-66*).

8 CLIENTS-CHRIS JOHNS AND HENRY AND SANDA CLARK

9 Cathryn Mayers ("Mayers"), a Division Financial Institutions Examiner, testified regarding
10 conversations she had with two other HUGHES and LFA clients, Chris Johns, and Henry and
11 Sanda Clark. (*Tr. p. 85, ll. 13-18, and p. 87, ll. 17-19*).

12 Mayers testified she spoke to Chris Johns ("Johns") on two occasions, July 2 and 5, 2012.
13 (*Tr. p. 87, ll. 21-25 to p. 88, ll. 1-2*). Mayers testified that Johns lived in Tucson, Arizona and was
14 a client of HUGHES and LFA. (*Tr. p. 88, ll. 5-8*).

15 Mayers testified Johns said HUGHES was a good friend to his family and attended the same
16 church. (*Tr. p. 88, ll. 15-19*). Johns is 43 years old. (*Tr. p. 88, ll. 21-22*) Johns wanted to retire
17 by the time he was in his 50s, and had an aggressive risk tolerance. (*Tr. p. 88, ll. 21-23*). However,
18 Mayers testified that Johns' economic circumstances changed. In 2009, Johns lost his job and
19 wanted to be a conservative investor. (*Tr. p. 88, ll. 24-25 to p. 89, l. 1*). Johns gave HUGHES
20 \$50,000, the only amount of money he had, and told HUGHES to be conservative with it. (*Tr. p.*
21 *89, ll. 2-8*).

22 Mayers testified Johns told her his \$50,000 portfolio dropped to near \$30,000. (*Tr. p. 89, l.*
23 *15*). HUGHES told Johns that HUGHES was waiting for a market "crash" when the trend of the
24 market had been upward and encouraged him to stay the course, which is what Johns did. (*Tr. p.*
25 *89, ll. 17-21*). Johns indicated that he did not know much at all about investments and considered
26 himself to be unsophisticated. (*Tr. p. 90, ll. 1-9*). Eventually, according to Mayers, Johns' wife

1 became employed at JP Morgan Chase and moved their funds there. (*Tr. p. 89, ll. 23-25*).

2 Litteau also reviewed Johns' trading activity from January 2009 until December 2010. (*Tr.*
3 *p. 174, ll. 6-16, and 194, ll. 17-18*). Litteau observed a similar trading pattern as with Jones and
4 Masek, including a heavy utilization of the leveraged and inverse ETFs. (*Tr. p. 194, ll. 21-25*).
5 Litteau said the trading by HUGHES was not suitable for someone with Johns' investment
6 objective, financial situation, and investment experience, especially in light of Johns losing his job.
7 (*Tr. p. 195, ll. 1-21*).

8 Fritz prepared a summary report for the Johns accounts. (*Tr. p. 217, ll. 15-25 to p. 218, ll.*
9 *P.219, ll. 1-16 and Ex. S-65*). Fritz testified Johns and his wife had three accounts with HUGHES.
10 (*Tr. p. 217, ll. 15-17 and Ex. S-65*). One of the three accounts began with a deposit of \$49,899.93.
11 (*Tr. p. 218, ll. 13-15 and Ex. S-65*). Each of the three accounts lost money for a total loss of
12 \$29,280.29. (*Tr. p. 219, ll. 12-13 and Ex. S-65*). Most of the losses occurred in the account that
13 began with near \$50,000, losing near half the amount of the beginning deposit. (*Tr. p. 219, ll. 1-9*
14 *and Ex. S-65*).

15 Mayers also testified regarding conversations she had with Henry and Sanda Clark
16 ("Clarks"). Mayers testified she spoke with the Clarks on July 2, 2012, and then spoke to Sanda
17 Clark again on July 6, 2012. (*Tr. p. 90, 12-14*). One of the first things the Clarks told Mayers was
18 they had dealt with a prior adviser and had a negative experience with that person in that they lost
19 money. (*Tr. p. 90, ll. 16-21*). The Clarks told Mayers that they told HUGHES about the negative
20 experience and wanted him to be conservative and careful with their monies. (*Tr. p. 90, 18-23*).

21 Mayers testified the Clarks were in their 60s and both were musicians. (*Tr. p. 91, ll. 3-4*).
22 They did not have a pension and were relying on their investment account with HUGHES and any
23 social security they would receive. (*Tr. p. 91, ll. 4-8*).

24 HUGHES and LFA prepared an Investment Policy Statement and a standard questionnaire
25 for the Clarks. (*Ex. S-14*). The questionnaire had the brackets around conservative to moderate
26 conservative as the investment objective. (*Ex. S-14 at ACC088837*). Their Investment Policy

1 Statement listed their assets at \$350,000 and a time horizon of 20 years. (*Ex. S-14 at ACC088823*).
2 Also, HUGHES had total control over the securities purchased and sold for the Clarks as both the
3 Clarks and HUGHES signed LFA's Investment Management Agreement which granted HUGHES
4 control to open their account and manage it. (*Ex. S-14 at ACC088829 and ACC088835*).

5 The model asset allocation portfolio ("portfolio") prepared by HUGHES and LFA for the
6 Clarks included investing in a diverse set of bonds and stocks. (*Ex. S-14 at ACC088826*). The
7 portfolio was based on the Clarks' financial resources, financial goals, time horizon, tax status,
8 holding limitations, and risk tolerance. (*Id.*). The model portfolio "balances risk and reward and
9 attempts to achieve the stated objectives of the investment program." (*Id.*). The portfolio included
10 nearly 33 percent in bonds, 22.29 percent in large value stocks, and others stocks. (*Id.*).

11 The Clarks asked HUGHES about their account performance but HUGHES responded to
12 stay the course. (*Tr. p. 91, ll. 19-25*). HUGHES explained to the Clarks, according to Mayers, that
13 he expected a market crash and that was when the Clarks were going to make their money. (*Tr. p.*
14 *91, ll. 24-25 to p. 92, ll. 1-3*). HUGHES mentioned leverage to the Clarks and they interpreted it as
15 meaning "gambling" and were not comfortable with it. (*Tr. p. 92, ll. 3-5*).

16 Like Jones, the Clarks were sent an email from HUGHES and LFA at the end of June 2012
17 announcing they would no longer be managing their account. (*Ex. S-17*). This was sudden and
18 without warning. (*Id.*). HUGHES indicated that their account would be in three or four
19 investments that could be held for the foreseeable future. (*Id.*). In fact, according to Litteau, their
20 accounts, pending settlement, included the leveraged ETF, TBT, a security that could not be held
21 for the foreseeable future. (*Tr. p. 193, ll. 14-19, and Exs. S-24 at ACC002474, S-25 at*
22 *ACC002627, S-26 at ACC002552, and S-27 at ACC002589*).

23 Litteau reviewed the trading accounts that belonged to the Clarks from January 2009 until
24 June 2012. (*Tr. p. 174, ll. 6-16, and p. 190, ll. 8-13*). He reviewed their statement of assets, time
25 horizon, investment objective, and risk tolerance, and asset allocation. (*Tr. p. 190, ll. 20-25 to p.*
26 *191, ll. 1-8*). He also reviewed their trading records and found the same type and concentration of

1 ETFs as found in the other client accounts. (*Tr. p. 191, ll. 9-24*). Litteau also opined that at no time
2 did the Clark accounts look like the asset allocation portfolio in the Clarks' Investment Policy
3 Statement. (*Tr. p. 192, ll. 1-3*). Litteau concluded, as with the three other HUGHES and LFA
4 client accounts, that the inverse and leveraged ETFs in the Clark accounts were unsuitable in light
5 of their financial situation, investment experience, and investment objectives. (*Tr. p. 192, ll. 19-*
6 *21*).

7 Fritz prepared a summary report for the Clarks' accounts. (*Tr. p. 220, ll. 10-25 and Ex. S-*
8 *68*). Fritz testified the Clarks' total loss was \$10,487.97 due to the trading in the accounts. (*Tr. p.*
9 *221, ll. 1-5*).

10 Litteau testified that none of HUGHES' clients fit the characteristics of a client for whom
11 these leveraged ETFs would have been suitable. (*Tr. p. 196, ll. 15-18*) Litteau testified that the
12 person would have been "a very, very sophisticated professional trader, a very aggressive
13 speculator, a very wealthy person who has the risk bearing ability and is willing just to take very
14 short term, or in this case, longer term bets on the direction of the market." (*Tr. p. 196, ll. 4-14*)
15 None of HUGHES' clients fit this profile. (*Tr. p. 196, ll. 15-18*)

16 **HOLDING ETFs BEYOND THE RECOMMENDED HOLDING PERIOD**

17 The highly volatile and leveraged ETFs were unsuitable for each client according to their
18 financial situation, investment experience, and investment objectives. (*Tr. p. 181, ll. 23-25, p. 182,*
19 *ll. 4-8, p. 188, ll. 4-7, p. 190, ll. 1-2, p. 195, ll. 1-10, and p. 192, ll. 19-2*) In addition, the length of
20 time HUGHES held the leveraged and volatile ETFs exposed Jones, Masek, Johns, and the Clarks
21 to additional risk. (*Exs. S-69, S-71, and S-73*).

22 Litteau said that HUGHES held these ETFs for up to three months in the client accounts.
23 (*Tr. p. 180, ll. 13-14*). Litteau reiterated that the ETFs HUGHES used to trade in his client
24 accounts were not meant to be held longer than a day. (*Tr. p. 179, ll. 11-14 and ll. 17-18*). These
25 ETFs were not intended to provide a return over time. (*Id.*). He also said by holding the ETFs
26 longer than the prescribed one day, it subjects the clients to magnified risks because of the

1 leveraging and the daily reset, which increases or decreases the exposure depending on how the
2 market, segment, or benchmark moved during the day. (*Tr. p. 179, ll. 21-25 to p. 180, ll. 1-6*).

3 Fritz prepared reports for each of the client accounts showing how many shares of each ETF
4 in each client's account were being held on any given day. (*Exs. S-69, S-71, and S-73*).

5 Regarding the Jones account, Fritz testified that her report showed that the Jones account
6 held ETFs with the ticker symbols EDC, EDZ, ERY, FAS, FAZ, TBT, TNA, TYH, TYP, TZA, and
7 URE in both their TD Ameritrade and Scottrade account. (*Tr. p. 204, ll. 15-16 and Exs. S-69 and*
8 *S-73*). Fritz testified that the column to the right of her report, the one titled "share balance"
9 showed the number of shares of a particular ETF how many shares were held on that particular day.
10 (*Tr. p. 205, ll. 2-3 and S-69*). As examples, Fritz testified that that on August 20, 2009, the Jones
11 account held at one time 7,000 shares of EDZ. (*Tr. p. 205, ll. 4-6 and Ex. S-69*). On another
12 occasion, October 26, 2009, HUGHES had the Jones account hold 15,143 shares of EDZ, at a value
13 of \$117,260.96. (*Ex. S-69 at p. 2 of 32*). Instead of selling the ETFs, HUGHES held onto the ETFs
14 for days, weeks, and on some occasions, months. (*Exs. S-69 and S-73*).

15 Fritz testified that she prepared similar EFT reports for Masek, Johns, and the Clarks. (*Tr. p.*
16 *213, ll. 3-5 and ll. 12-22, p. 216, ll. 14-20, p. 219, ll. 24-25 to p. 220, ll. 1-3, and Exs. S-68, S-70, S-*
17 *72, and S-74*). Each of the ETF reports showed the same ETFs as in the Jones account, that the
18 ETFs were held for longer than a day, and subjected the accounts to additional risks. (*Exs. S-68, S-*
19 *70, S-72, and S-74*).

20 **LICENSING STATUS DISCLOSURE**

21 Steger testified that an investment advisor is accountable for the contents of its written
22 supervisory procedures ("WSP/Compliance Manual"). (*Tr. p. 166, ll. 16-22*). Steger testified he
23 requested HUGHES to provide a copy of LFA's WSP/Compliance Manual in effect since April
24 2008 and any updates to the manual. (*Tr. p. 116, ll. 23 to p. 117, ll. 1-3*). HUGHES provided one
25 version of LFA's WSP/Compliance Manual. (*Tr. p. 117, ll. 4-11 and Ex. S-13*) LFA's
26 WSP/Compliance Manual states that HUGHES is the only investment adviser representative. (*Ex.*

1 *S-13 at ACC 088747*). LFA's WSP/Compliance Manual requires that individuals associated with
 2 LFA providing investment advisory services be licensed as investment adviser representatives before
 3 providing advisory services to clients. (*Ex. S-13 at ACC088748*).

4 Furthermore, Steger testified that LFA disclosed its business practices to their clients through
 5 regulatory Form ADV filings. (*Tr. p. 99, ll. 9-12*) LFA filed its FORM ADV Part II on February 28,
 6 2008, February 19, 2010, and April 15, 2011. (*Exs. S-5b, S-6b, and S-7b*) The Form ADV Part II filed
 7 on February 28, 2008, and again on February 19, 2010, stated in its Schedule F, Item 1D that
 8 "Individuals associated with LFA will provide its investment advisory services. These individuals
 9 are appropriately licensed...." (*Exs. S-5b and S-6b*). LFA did not include similar language in its
 10 Form ADV Part II filed on April 15, 2011. (*Ex. S-7b*). Steger testified that HUGHES was never
 11 licensed as an investment adviser representative. (*Tr. p. 101, ll. 7-25 to p. 102, ll. 1-5, and Ex. S-*
 12 *55*).

13 V.

14 ARGUMENT

15 A. HUGHES acted as an unlicensed investment adviser representative in violation of 16 A.R.S. § 44-3151.

17 A person shall not transact business in Arizona as an investment adviser representative
 18 unless that person is licensed or in compliance with the IM Act. *See* A.R.S. § 44-3151. Under the
 19 IM Act, an investment adviser representative is defined as follows:

20 "...any partner, officer or director of an investment adviser, any individual who
 21 occupies a status or performs functions similar to a partner, officer or director of an
 22 investment adviser or any other individual who is employed by or associated with
 23 an investment adviser, except clerical or ministerial personnel, and who does any of
 the following:

24 (a). Makes any recommendations or otherwise renders advice regarding securities.

25 (b). Manages accounts or portfolios of clients.

26 (c). Determines which recommendation or advice regarding securities should be
 given to a client if the individual is a member of the investment adviser's investment
 committee that determines general investment advice to be given to clients or the

1 individual determines general client advice if the investment adviser has no
2 investment committee, except that if an investment adviser has more than five
3 individuals who make recommendations or give advice, only the supervisors of
4 those individuals are investment adviser representatives.

5 (d). Solicits, offers or negotiates for the sale of or sells investment advisory services.

6 (e). Directly supervises employees who perform any of the acts described in this
7 paragraph.

8 *See* A.R.S. § 44-3101(6).

9 At all times, HUGHES was LFA's sole owner, member, managing member, and
10 compliance officer. On behalf of LFA, HUGHES made recommendations or otherwise rendered
11 advice regarding securities when HUGHES bought and sold the ETFs within his client accounts.
12 HUGHES managed his clients' accounts when he made the decisions regarding the accounts, as to
13 which ETFs to purchase and sell and in what quantity, for his clients.

14 When LFA was first licensed as an investment adviser in Arizona in April 2008, LFA was a
15 sole proprietorship. As a sole proprietorship LFA and HUGHES were one and the same thus,
16 HUGHES, dba LFA, was licensed as an investment adviser. Hughes was not required to license
17 separately as an investment adviser representative under the IM Act.

18 On December 8, 2009, when HUGHES changed LFA's organizational form converting
19 LFA to a limited liability company, LFA became a separate and distinct entity from HUGHES. At
20 that time, HUGHES was not associated with a federal covered adviser nor exempt from licensure,
21 thus, he was required to be licensed as an investment adviser representative in association with
22 LFA. Steger testified that HUGHES was never licensed as an investment adviser representative in
23 association with LFA. After December 8, 2009, Hughes acted as an unlicensed investment adviser
24 representative in violation of the licensing requirements of the IM Act. *See* A.R.S. § 44-3151(A).

25 **B. LFA employed HUGHES, an unlicensed investment adviser representative, in**
26 **violation of A.R.S. § 44-3151.**

An investment adviser that is required to be licensed shall not employ an investment adviser
representative unless the investment adviser representative is licensed under the IM Act. *See* A.R.S. §

1 44-3151(C). Steger testified that LFA was a licensed investment adviser with the Commission
2 beginning April 2008. Jones, Masek, Mayers, and Steger each testified that HUGHES was the only
3 investment adviser representative at LFA. As noted above, HUGHES was never licensed as an
4 investment adviser representative. Thus, LFA employed an unlicensed investment adviser
5 representative in violation of the licensing requirements of the IM Act. *See* A.R.S. § 44-3151(C).

6 C. **LFA's conduct is grounds to revoke its license as an investment adviser, assess**
7 **restitution and penalties, and order a cease and desist pursuant to A.R.S. § 44-**
8 **3201.**

9 The Commission may revoke an investment adviser's license if the Commission finds that it
10 is in the public interest and if the investment adviser engaged in one of 14 acts, practices, or
11 transactions. *See* A.R.S. § 44-3201. Additionally, the investment adviser is also subject to an
12 order of administrative penalties, an order to cease and desist from engaging in the act, practice, or
13 transaction, and an order of restitution if the investment adviser engaged in conduct enumerated in
14 paragraphs 6, 12, or 13 of A.R.S. § 44-3201(A). *See* A.R.S. § 44-3201(B).

15
16 1. **LFA employed an unlicensed investment adviser representative and in**
17 **doing so violated an IM Act statute, A.R.S. § 44-3151(C); therefore, LFA is**
18 **subject to the revocation of its investment adviser license pursuant to A.R.S.**
19 **§ 44-3201(A)(3).**

20 The Commission may revoke an investment adviser's license if the investment adviser
21 violates a provision of the IM Act. *See* A.R.S. § 44-3201(A)(3). The IM Act requires an
22 investment adviser not to employ an investment adviser representative unless that investment adviser
23 representative is licensed. *See* A.R.S. § 44-3151(C).. LFA, an investment adviser, employed
24 HUGHES as investment adviser representative. As such, LFA was required to have HUGHES
25 licensed as an investment adviser representative. HUGHES was unlicensed. Because LFA
26 employed an unlicensed investment adviser representative, LFA violated an IM Act statute.

1 Therefore, LFA, by employing an unlicensed investment adviser representative in violation of
2 A.R.S. § 44-3151(C), engaged in an act or practice that subjects it to a revocation of its license.
3 See A.R.S. § 44-3201(A)(3).

4 **2. LFA engaged in dishonest and unethical conduct with the meaning of**
5 **A.R.S. § 44-3201(A)(13) as defined by A.A.C. R14-6-203(A)(8) when LFA**
6 **misrepresented that HUGHES was properly licensed to provide investment**
7 **advisory services when he was not licensed; therefore, LFA is subject to the**
8 **revocation of its investment adviser license pursuant to A.R.S. § 44-**
9 **3201(A)(13).**

10 The Commission may revoke an investment adviser's license if the investment adviser
11 engaged in dishonest or unethical practices in the securities industry. See A.R.S. § 44-
12 3201(A)(13). Dishonest and unethical practices are defined by rule and include, but are not limited
13 to, 19 practices. See A.A.C. R14-6-203.

14 An investment adviser has an affirmative and ongoing duty of accurate disclosure. An
15 investment adviser is required by A.R.S. § 44-3153 to file a Form ADV through the Investment
16 Advisory National Depository ("IARD") to become licensed. See A.R.S. § 44-3153. This form
17 discloses the nature of the services to be offered by the investment adviser and the investment
18 adviser and its representatives qualifications. A.R.S. § 44-3159 requires an investment adviser and
19 investment adviser representatives to file through the IARD a supplemental statement showing any
20 material changes in the facts contained in its original application within thirty days of the change.
21 Furthermore, the investment adviser is required by A.A.C. R14-6-205 to deliver the Form ADV to
22 its clients. See A.A.C. R14-6-205.

23 An investment adviser engages in dishonest and unethical practices by misrepresenting the
24 qualifications, or licensing, of its investment adviser representative. See A.A.C. R14-6-203(A)(8).
25 For all relevant times, LFA specifically represented and disclosed, through its Form ADV filings
26 and its WSP/Compliance Manual, that its investment adviser representatives would be property

1 licensed. Because LFA represented and disclosed its investment adviser representatives would be
 2 properly licensed, LFA misrepresented to its clients the qualifications of HUGHES, who was
 3 unlicensed. Accordingly, LFA engaged in a dishonest and unethical practice that subjects it to a
 4 revocation of its license. *See* A.R.S. § 44-3201(A)(13).

5 **3. LFA engaging in dishonest and unethical conduct is grounds to assess**
 6 **restitution and penalties, and order a cease and desist pursuant to A.R.S. §**
 7 **44-3201.**

8 LFA, in addition to the revocation of its investment adviser license, is subject to an order of
 9 administrative penalties, an order to cease and desist from engaging in the act, practice, or
 10 transaction, and an order of restitution if the investment adviser engaged in conduct enumerated in
 11 paragraphs 6, 12, or 13 of A.R.S. § 44-3201(A). *See* A.R.S. § 44-3201(B). Specifically, LFA has
 12 engaged in dishonest and unethical conduct within the meaning of A.R.S. §44-3201(A)(13) as
 13 defined by A.A.C. R4-6-203(A)(8) when LFA misrepresented the nature of the investment
 14 advisory services being offered, by representing that HUGHES was properly licensed to provide
 15 investment advisory services when he was not licensed.

16 **D. HUGHES violated the antifraud provisions of the IM Act when he repeatedly**
 17 **minimized and misled Masek as to the effect trading was having on Masek's**
 18 **account, emailed Jones and Clarks that he had placed them in investments they**
 19 **could hold for the foreseeable future when the investments were in the highly**
 20 **volatile, leveraged ETFs, and principally traded in unsuitable highly volatile,**
 21 **leveraged ETFs.**

22 Under the IM Act, it is a fraudulent practice and unlawful for a person, in connection with a
 23 transaction or transactions within or from this state involving the provision of investment advisory
 24 services, directly or indirectly, to do any of the following: (1) employ any device, scheme or artifice
 25 to defraud; (2) make any untrue statement of material fact, or fail to state any material fact
 26 necessary in order to make the statement made, in the light of the circumstances in which it was

1 made, not misleading; (3) misrepresent any professional qualifications with the intent that the
2 client rely on the misrepresentation; or (4) engage in any transaction, practice or course of business
3 that operates or would operate as a fraud or deceit. *See* A.R.S. § 44-3241(A).

4 There is little to no Arizona case law interpreting A.R.S. § 44-3241(A). Because A.R.S. §
5 44-3241(A) is patterned after A.R.S. § 44-1991(A), the Division will look to case law interpreting
6 A.R.S. § 44-1991(A) of the Securities Act for guidance.

7 In *State v. Gunnison*, the Arizona Supreme Court held that scienter (i.e., intent to defraud) is
8 not a necessary element of a violation of A.R.S. § 44-1991(A)(2). 127 Ariz. 110, 113, 618 P.2d
9 604, 607 (1980)(en banc) Reliance also is not an element of a violation of A.R.S. § 44-1991(A)(2).
10 *See Rose v. Dobras*, 128 Ariz. 209, 214, 624 P.2d 887, 892 (Ct.App. 1981). As explained in *Aaron*
11 *v. Fromkin*, “[t]he elements of securities fraud are articulated within the statute itself.” 196 Ariz.
12 224, 227, 994 P.3d 1039, 1042 (Ct. App. 2000). Nothing in the language of A.R.S. § 44-1991(A)
13 speaks of reliance. *See* A.R.S. § 44-1991(A).

14 A “material fact” is a statement or omission that would have assumed actual significance in
15 the deliberations of the reasonable buyer. *See Aaron*, 196 Ariz. at 227, 994 P.3d at 1042. Arizona
16 courts have held that the issuer of securities has an affirmative duty not to mislead potential
17 investors. *See Trimble v. American Sav. Life Ins. Co.*, 152 Ariz. 548, 553, 733 P.2d 1131, 1136 (Ct.
18 App. 1986).

19 The evidence elicited at hearing clearly establishes three frauds committed by HUGHES in
20 connection with the advisory services offered to HUGHES’ clients.

21 **1. HUGHES repeatedly minimized and misled Masek as to the effect trading was**
22 **having on Masek’s account.**

23 HUGHES violated the antifraud provisions of the IM Act when he repeatedly minimized and
24 misled Masek as to the effect trading was having on Masek’s account. *See* A.R.S. § 44-3241(A).
25 Masek trusted HUGHES to safely manage Masek’s DROP funds as those were earmarked to pay
26 Masek’s mortgage payments. As Masek reviewed the balance of his account, beginning with the

1 first month, Masek noticed the total balance decreased. Masek noticed the continual drop in his
2 account balance and repeatedly contacted HUGHES to explain to him why his account kept
3 dropping in light of his moderate risk profile.

4 HUGHES responded to Masek by hiding behind economic jargon that would sound
5 reasonable to a person like Masek who was unfamiliar with the terminology. HUGHES repeatedly
6 told Masek to "remember the seven year curve" as an explanation for the declines in Masek's
7 account. HUGHES even discounted the losses by telling Masek not to look at his statements.
8 However, Litteau testified that the seven year curve refers to a business cycle and HUGHES'
9 trading was inconsistent with trying to track a business cycle.

10 Hughes purchased securities that were unsuitable for Masek and suffered losses. HUGHES
11 dismissed Masek's concerns and misrepresented what was occurring in the account.

12 **2. HUGHES informed clients he had placed them in investments they could own for**
13 **the foreseeable future, but in reality, he substantially increased their investment**
14 **risk by concentrating their accounts in highly volatile, leveraged ETFs meant to**
15 **be traded daily, not held long term.**

16 HUGHES violated the antifraud provisions of the IM Act when he represented in an email
17 that, since he was no longer going to be providing advisory services, Jones and the Clarks could hold
18 those investments for the foreseeable future when in fact their accounts included highly volatile,
19 leveraged ETFs meant for day trading, not long-term positions. See A.R.S. § 44-3241(A).

20 HUGHES sent Jones and the Clarks an email on June 30, 2012, informing them that he was no
21 longer going to be providing advisory services. HUGHES left Jones and the Clarks with accounts
22 including TBT, a highly volatile and leveraged ETF, and not meant for a long term hold, as noted in
23 the prospectus for the ETF. Despite the fact that both Jones and the Clarks had limited financial
24 knowledge, HUGHES left them in a vulnerable position since he advised them to continue holding the
25 securities for the foreseeable future when they were holding an ETF that were not meant to be held
26 longer than a day. For Jones and the Clarks, HUGHES only served to further increase their exposure

1 to risk. HUGHES' statements in the email were opposite to his actions in their accounts. Thus,
2 HUGHES misrepresented to Jones and the Clarks that they could hold the securities for the
3 foreseeable future.

4 **3. HUGHES principally traded in unsuitable highly volatile, leveraged ETFs for**
5 **LFA's clients.**

6 HUGHES principally traded in unsuitable highly volatile, leveraged ETFs for LFA's and his
7 clients and in doing so violated the antifraud statute. *See* A.R.S. § 44-3241(A). It is a fraudulent
8 practice to place clients in securities that are not suitable for them. *See* A.A.C. R4-6-207. The
9 suitability rule is as follows:

10 A. Except as otherwise provided in subsection (B), it shall constitute a fraudulent
11 practice within the meaning of A.R.S. § 44-3241(A)(4) for any person to provide
12 investment advisory services to any client, other than in connection with impersonal
advisory services, unless the person:

13 1. Before providing any investment advisory services, and as appropriate thereafter,
14 makes a reasonable inquiry of the client as to the financial situation, investment
experience, and investment objectives of the client; and

15 2. Reasonably determines that the investment advisory services are suitable for the
16 client based upon the information obtained from the client in accordance with
subsection (A)(1) above;

17 B. With respect to federal covered advisers, the provisions of this Section only apply to
the extent permitted by Section 203A of the Investment Advisers Act of 1940.

18 *See* A.A.C. R4-6-207.

19 The Division's expert, Litteau, whose extensive career in the securities industry qualified him
20 to offer his opinions given at the hearing, testified that these highly volatile, leveraged ETFs were
21 unsuitable for HUGHES' clients. Litteau reviewed each client's financial situation, investment
22 experience, and investment objectives and opined that HUGHES purchased securities that were not
23 suitable for each client's circumstances.

24 HUGHES discussed with each of his clients: their financial situation, investment experience,
25 and investment objectives. HUGHES received instructions for how to manage his client accounts
26 through either the Investment Policy Statements or through verbal conversations and agreed to follow

1 those instructions through the Investment Management Agreements he signed. Regardless of the type
2 of investment objective - whether it was conservative, moderate conservative, moderate, or moderate
3 aggressive - HUGHES traded in the same highly volatile, leveraged ETFs, which were unsuitable in
4 all those instances.

5 HUGHES pursued a strategy of concentrating his client accounts in highly volatile, leveraged
6 ETFs regardless of his client's financial situation, investment experience, and investment objectives.
7 These ETFs presented a series of risks. First, there is leverage risk. Each of the ETFs was leveraged
8 two or three times. For each one percent change in the index, there would be a corresponding two or
9 three percentage change in the index, thereby magnifying the effect on the account. Second, there is
10 inverse risk. If the underlying index moves in the opposite direction than expected, there will be a loss
11 of funds. Third, the underlying index itself may be risky. For example, an index consisting of small
12 and/or mid-sized capitalized companies present greater investment risk than found with larger more
13 established companies.

14 Litteau testified that these highly volatile, leveraged ETFs were only suitable for speculative
15 investors, those investors who had significant assets, or anyone else who could afford the losses.
16 None of HUGHES' clients fit this profile. HUGHES' clients did not have the financial wherewithal to
17 withstand any significant kind of risk of trading losses these ETFs could inflict. Each of the client
18 accounts represented nearly all the funds each client possessed. Each had their objectives: (1) Jones
19 to retire or to use to live, depending the health of her husband after his heart attack; (2) Masek who
20 counted on his funds to pay his mortgage, (3) Johns who lost his job and needed to preserve his
21 remaining \$50,000, and (4) the Clarks who wanted to preserve their funds as they were independent
22 contractors. Instead, HUGHES bought and sold highly volatile, leveraged ETFs.

23 HUGHES ignored his clients' financial situation, investment experience, and investment
24 objectives and ignored the prospectuses regarding who should own these ETFs and how the ETFs
25 should be traded. Because of this, HUGHES placed his clients in unsuitable investments and
26 committed fraud when he misrepresented that he would follow the client financial situation,

1 investment experience, and investment objectives. As a result of HUGHES' conduct, the clients
2 collectively lost \$340,806.30.

3 **E. The marital community of HUGHES and Respondent Spouse is subject to**
4 **liability for HUGHES' violations of the IM Act.**

5 Respondent Spouse was joined to this action pursuant to A.R.S. § 44-3291(C) to determine
6 the liability of the marital community. Pursuant to A.R.S. § 25-211, all property acquired by either
7 husband or wife during the marriage is the community property of the husband and wife except for
8 property that is acquired by gift, devise, descent or is acquired after service of a petition for
9 dissolution of marriage, legal separation or annulment if the petition results in a decree of
10 dissolution of marriage, legal separation or annulment. In addition, "either spouse may contract
11 debts and otherwise act for the benefit of the community." A.R.S. § 25-215(D). "The presumption
12 of law is, in the absence of the contrary showing, that all property acquired and all business done
13 and transacted during coverture, by either spouse, is for the community." *Johnson v. Johnson*, 131
14 Ariz. 38, 45, 638 P.2d 705, 712 (1981) (*en banc*)(quoting *Benson v. Hunter*, 23 Ariz. 132, 134-135,
15 202 P.2d 233, 233-234 (1921).

16 Both HUGHES and Respondent Spouse were married during all relevant times. As a result, the
17 presumption is that all business conducted by HUGHES and in turn, the debts he incurred during that
18 same timeframe, was conducted on behalf of the marital community. HUGHES and Respondent
19 Spouse failed to appear at the hearing to present any evidence that HUGHES was not acting for his
20 own benefit, and for the benefit or in furtherance of their marital community. Therefore, the marital
21 community of HUGHES and Respondent Spouse is liable for HUGHES' violations of the IM Act.

22 **CONCLUSION**

23 The evidence produced at hearing includes the following:

24 A. HUGHES acted as an unlicensed investment adviser representative in violation of
25 A.R.S. § 44-3151(A);

26 B. LFA employed HUGHES, an unlicensed investment adviser representative, in

1 violation of A.R.S. § 44-3151(C);

2 C. LFA's conduct of employing an unlicensed investment adviser representative in
3 violation of A.R.S. § 44-3151(C), and of engaging in dishonest and unethical conduct by
4 misrepresenting it would employ a licensed investment adviser, subjects LFA to a revocation of its
5 investment advisor license, restitution, penalties, and an order to cease and desist pursuant A.R.S.
6 § 44-3201; and

7 D. HUGHES (1) misled Masek by repeatedly minimizing the effect trading was
8 having on Masek's account, (2) emailed Jones and the Clarks that they could hold for the
9 foreseeable future the investments purchased by HUGHES, despite the fact that the investment
10 were in highly volatile, leveraged ETFs, and (3) principally traded in unsuitable highly volatile,
11 leveraged ETFs in his client accounts, in violation of A.R.S. § 44-3241(A).

12 Based upon the evidence admitted during the administrative hearing, the Division respectfully
13 requests this tribunal to:

14 1. Order LFA to permanently cease and desist from violating the IM Act, pursuant to
15 A.R.S. §§ 44-3201(B) and 44-3292;

16 2. Order LFA to pay the state of Arizona administrative penalties of \$75,000 for violating
17 the IM Act, pursuant to A.R.S. §§ 44-3201(B), and 44-3296;

18 3. Order the revocation of LFA's license as an investment adviser pursuant to A.R.S. §
19 44-3201(A);

20 4. Order HUGHES to permanently cease and desist from violating the IM Act, pursuant
21 to A.R.S. § 44-3292;

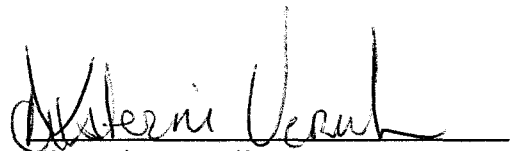
22 5. Order HUGHES to pay the state of Arizona administrative penalties of \$75,000 for
23 violating the IM Act, pursuant to A.R.S. § 44-3296;

24 6. Order HUGHES to take affirmative action to correct the conditions resulting from
25 his acts, practices or transactions, including a requirement to pay restitution in the amount of
26 \$340,806.30, pursuant to A.R.S. § 44-3292;

1 7. Order that the marital community of HUGHES and Respondent Spouse be jointly
2 and severally liable with HUGHES to pay restitution in the amount of \$340,806.30 and
3 administrative penalties in the amount of \$75,000 pursuant to A.R.S. §§ 25-215 and 44-3291(C);
4 and

5 8. Order any other relief that the Commission deems appropriate.
6

7 RESPECTFULLY SUBMITTED this 15th day of October, 2013.
8

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10 Aikaterine Vervilos
11 Attorney for the Securities Division of the
12 Arizona Corporation Commission
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1 ORIGINAL AND EIGHT (8) COPIES of the foregoing
2 filed this 15th day of October, 2013, with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 W. Washington St.
6 Phoenix, AZ 85007

7 COPY of the foregoing hand-delivered
8 this 15th day of October, 2013 to:

9 Administrative Law Judge Marc E. Stern
10 Arizona Corporation Commission/Hearing Division
11 1200 W. Washington St.
12 Phoenix, AZ 85007

13 COPY of the foregoing mailed
14 this 15th day of October, 2013, to:

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